Supreme Court, U.S.
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No.

In the

Supreme Court of the United States

ROBERT C. COBORN,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

I. Whether The Petition Should Be Granted Because The Opinions Below Conflict With The Long Established Precedents Of This Court That Taxable Income Should Be Computed On An Annual Basis, Not On A Transactional Basis?

II. Whether The Petition Should Be Granted Because The Opinions Below Conflict With The Precedents Of The Fifth Circuit Concerning The Use Of Subsequent Events To Establish Lack Of Worthlessness When A Taxpayer Claims A Bad Debt Loss?

III. Whether A Review Of The Cases Concerning Losses Claimed Pursuant To Section 165 Of The Internal Revenue Code Where The Courts Must Determine If A Taxpayer Has A Reasonable Prospect Of Recovering The Loss Based On A Claim For Reimbursement Show That The Courts Reject Considering Facts Not Reasonably Foreseeable As Of The Close Of The Relevant Tax Year?

IV. Whether The Petition Should Be Granted Because A Detailed Comparison Of The Proper Application Of The Annual Accounting Principle In The Following Cases Demonstrates The Grievous Error Of The Eighth Circuit And The United States Tax Court In This Case?

V. Whether The Petition Should Be Granted Because The Opinions Below Fail To Properly Take Into Account The Fact That The Internal Revenue Service, In Its Role As A Creditor Of EPL, Essentially Decided That Petitioner's Debt With EPL Was Worthless When It Accepted An Offer In Compromise On Accrued But Unpaid Federal Payroll Tax Obligations?

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STATEMENT OF JURISDICTION

The judgment of the United States Court of Appeals for the Eighth Circuit ("Court of Appeals") was entered on December 23, 1999.

The jurisdiction of this Court is invoked under 26 U.S.C. § 7482 (a)(1) (1999), and 28 U.S.C. § 1254 (1999).

STATUTORY PROVISIONS INVOLVED

Section 166(d) of the Internal Revenue Code provides:

(d) Nonbusiness debts –

(1) General Rule – In the case of a taxpayer other than a corporation –

(A) subsection (a) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a

capital asset held for not more than 1 year.

(2) Nonbusiness debt defined – For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than –

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

STATEMENT OF THE CASE

A. Jurisdiction Background.

The jurisdiction of the United States Tax Court was based on the issuance by the Internal Revenue Service of a Statutory Notice of Deficiency on June 17, 1994, setting forth its audit determinations for Mr. Coborn's 1988, 1989, 1990 and 1991 tax years, pursuant to Section 6212 of the Internal Revenue Code (I.R.C.). I.R.C. § 6211, defines a deficiency as the amount by which the correct tax (as determined by the Commissioner) exceeds the sum of the amount shown as tax by the taxpayer on the taxpayer's return as well as any amounts previously assessed against that taxpayer. In this case, there had been no previous assessments or notices of deficiency prior to the Statutory Notice of Deficiency issued on June 17, 1994.

The Statutory Notice of Deficiency will set forth the tax years, the amounts of the deficiencies (as determined by the Commissioner), the Commissioner's explanation of his rationale for determining that there is a deficiency in tax for each year, an explanation of any additions to tax (penalties) that the Commissioner of Internal Revenue determines to be due and an explanation of the taxpayer's options. Among the options available to the taxpayer, pursuant to I.R.C. § 6213, is a Petition to the United States Tax Court to appeal the Commissioner's findings to that Court. As authorized by I.R.C. § 6213, Petitioner filed his Petition with the United States Tax Court on September 16, 1994, having mailed his petition to the Court within the 90 day period required to give the Tax Court jurisdiction over this proceeding. I.R.C. § 7502 (timely mailing treated as timely filing). Neither party raised any jurisdictional issues in the proceedings before the Tax Court.

B. Facts Material to the Question Presented

After serving in the United States Navy as a fighter pilot in World War II, Petitioner returned home to Minnesota and a family business, Coborn's, Inc., a retail grocery store chain head-quartered in St. Cloud, Minnesota. Petitioner and his brothers built the business from a one-store operation to a business with grocery stores, discount stores, liquor stores and convenience stores with more than twenty facilities in five states. By the time Petitioner retired from this business as a shareholder and officer in 1988, the gross revenues of the business were approximately $200,000,000. Today,

the gross revenues of Coborn's, Inc. total approximately $500,000,000 a year.

Petitioner first invested in a corporation called Environmental Protection Laboratories, Inc. (sometimes hereinafter "the corporation" or "EPL") in June 1972. As a result of various transactions, Petitioner's share ownership gradually increased until April 1984 when Petitioner held 79 percent of the stock of EPL and a Mr. Gerald Tjernagel the remaining 21 percent. This division of stock ownership remained the same until 1992. Mr. Tjernagel served as EPL's Technical Director and Director of Research and Development. EPL initially concentrated on water testing but then branched into manufacturing microbiology products.

Beginning in 1973, Petitioner made a series of transfers of funds to EPL. The parties stipulated, before the Tax Court trial, that Petitioner had substantiated making at least $1,571,428.60 in transfers of funds from 1973 through 1988.

Petitioner intended these transfers to be debt and intended to be repaid for these transfers. Petitioner executed a variety of documents reflecting his treatment of these transfers as debts. Respondent determined, as an alternative position to his determination that Petitioner had failed to establish worthlessness, that a debtor-creditor relationship had not been established between EPL and Petitioner.

EPL also received loans from various banks throughout these years up to and including 1988. These loans were secured by security interests in EPL's assets.

All of the banks that loaned funds to EPL insisted that Petitioner subordinate his loans to their loans. Petitioner's loans to EPL were unsecured through 1988.

In 1983, Petitioner asked his son, Robert C. Coborn, Jr., to review the company's business to determine if EPL should continue to conduct business and, if it should continue, what opportunities it should pursue. Robert C. Coborn Jr. was a businessman with substantial experience in construction and lyophilization products. Lyophilized products are freeze-dried microorganisms.

Robert C. Coborn, Jr. recommended continuing the business and pursuing four different lines of business. The first line of business was a computer software product, called Noscom, designed for the recording and tracking of Noscomial infections, which are infections a patient receives in the hospital. The second line of business that EPL planned to pursue was general testing including testing food products, water and waste water for municipalities and water, feed and forage for the agricultural market.

A third line of business was the prepared culture media business. Prepared culture media are products for the growth of bacteria, yeast and mold. Laboratories purchase these products from media production companies instead of spending time, effort and money producing their own media.

Lyophilized or freeze-dried microorganisms were the fourth line of business EPL planned to pursue. These microorganisms are used for quality control to test

the quality of products; determine the proficiency of laboratories and the competency of individual laboratory personnel. These products also had uses for industry, pharmaceutical companies and the industrial marketplace.

Petitioner, his son and the Board of Directors of EPL anticipated that the pursuit of this business plan would lead to repayment of the funds loaned to EPL by Petitioner either through the sale of the entire company, the sale of one or more divisions of the company, a public offering or private placement, increased third party asset-based lending made possible by the growth of the company's accounts receivable and inventory, or revenue growth. They anticipated that they could implement the business plan within three to five years at a cost between $1,500,000 and $1,900,000.

Gerald Tjernagel played a key role in the implementation and development of the business plan. From the beginning of his association with EPL on April 30, 1982, Mr. Tjernagel served as the Technical Director and Director of Research and Development. He managed EPL's compliance with Food and Drug Administration (hereinafter FDA) requirements and developed over 100 products for EPL. Until very recently, no one else in EPL, either officer or employee, could fulfill these two roles of FDA compliance and product creation and development. When Mr. Tjernagel began his association with EPL, he purchased stock in EPL by exchanging a right to receive royalties on one of his products for a significant stock interest in EPL. Mr. Tjernagel did not want to see his percentage of stock ownership diluted or reduced because he regarded his

interest in EPL as his retirement "nest egg." Petitioner therefore lent funds to EPL rather than making equity investments in EPL to protect Mr. Tjernagel's stock interest in EPL and retain his valuable services for EPL.

Several unanticipated and unforeseeable business reverses hindered and obstructed the development of the business plan. EPL's testing business suffered from efforts by the Minnesota Department of Agriculture to offer testing programs that directly competed with EPL's water testing for dairy farms and feed and forage testing for the agricultural market. EPL's infection control software met unanticipated sales resistance from its potential customers and was undercut on price by competing products. EPL's prepared culture media products generated significant revenue but not the net profit anticipated at the time the business plan was adopted.

From 1984 through 1988, EPL suffered increasingly severe financial distress. EPL's tax returns show the following losses for each year from 1984 through 1987:

1984	($233,427)
1985	($98,189)
1986	($518,838)
1987	($463,589)

The 1988 results also would show a loss of $717,119 without the cancellation of indebtedness income described below.

EPL's financial distress lead to its failure to fully pay the payroll taxes due to the Internal Revenue Service for the last three quarters of 1985, all four quarters of 1986 and the first two quarters of 1987. These tax liabilities were resolved through an Offer in Compromise with the Internal Revenue Service. When the Internal Revenue Service resolves a federal tax liability pursuant to an Offer in Compromise, they accept a payment of less than the full balance due from a taxpayer in full satisfaction of the full tax debt based on the taxpayer's inability to pay the full balance due. An Offer in Compromise provides the Internal Revenue Service with some revenue, presumably the best that a taxpayer can produce in the taxpayer's financial circumstances and provides relief for the taxpayer from paying the full amount of the tax due. Petitioner, not EPL, provided the funds for the Offer in Compromise. In 1989 and 1990, the Internal Revenue Service concluded that the amount offered pursuant to the Offer in Compromise "greatly exceeds" the amount the Internal Revenue Service would realize on the sale of EPL's assets. The Revenue Officer's Report recommending acceptance of the offer especially pointed to difficulties in realizing significant amounts from the sale of EPL's inventory.

As a result of its financial distress, EPL lacked operational funds and was unable to pay its bills as they came due. The Petitioner and the Board of Directors considered a bankruptcy filing. As of the end of 1988, Petitioner cancelled EPL's debt to Petitioner in the amount of $1,600,000, based on his and the Board of Directors conclusion that this debt was worthless. As a result of this cancellation of debt, EPL realized

cancellation of indebtedness income, as shown on its corporate income tax return, in the amount of $1,600,000. Similarly, the amount of debt owed to Petitioner by EPL was also reduced by $1,600,000. Petitioner claimed a non-business bad debt deduction in the amount of $1,600,000 on his 1988 federal income tax return.

EPL's balance sheet for its year ended December 31, 1988 showed that its liabilities exceeded assets and shareholders' stock investment by $1,349,009, even after the debt cancellation of $1,600,000. The balance sheet for December 31, 1988 showed the following readily marketable assets:

Accounts Receivable	142,426
Inventory	117,708
Furniture and Equipment	49,081
Vehicles	13,116
	$322,331

The balance sheet for December 31, 1988 showed the following liabilities having priority over

Petitioner's claims:

Loans from parties other than Petitioner	628,241
Accrued Payroll and Sales Taxes	277,671
Accounts Payable	226,733

$1,132,645

Most of EPL's debt to third parties was owed to banks and secured by its accounts receivable, inventory and equipment

REASONS FOR GRANTING THE WRIT

I. THE PETITION SHOULD BE GRANTED BECAUSE THE OPINIONS BELOW CONFLICT WITH THE LONG ESTABLISHED PRECEDENTS OF THIS COURT THAT TAXABLE INCOME SHOULD BE COMPUTED ON AN ANNUAL BASIS, NOT ON A TRANSACTIONAL BASIS.

This court established the principle that taxable income should be computed on an annual basis at a very early date in the history of the federal income tax. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931). In *Sanford & Brooks Co.*, the taxpayer was a Delaware corporation that carried out a contract with the United States government to dredge the Delaware River. Its expenses incurred in performing the contract exceeded the income received by $176,271.88. During the years it performed the contract, it filed annual federal income tax returns reporting these income and expense figures. Based on its contract with the government, it filed suit against the government for the amount by which its expenses exceeded its revenues on the contract. It won the suit and received a damage award from the Court of Claims

for exactly the amount by which expenses exceeded income plus interest.

The taxpayer did not report the amount of the judgment based on its argument that it received no profit on the transaction considered as a whole. The Commissioner of Revenue contended that income and expenses should be reported on an annual basis, not on the basis of particular transactions. The Court noted that the parties' arguments squarely presented the issue of whether the "gain or profit which is the subject of the tax may be ascertained, as here, on the basis of fixed accounting periods, or whether, as is pressed upon us, it can only be net profit ascertained on the basis of particular transactions of the taxpayer when they are brought to a conclusion."

The Court decided for the Commissioner of Revenue based on the practicalities of computing taxable income and administrative convenience. The Court noted:

> "The Sixteenth Amendment was adopted to enable the government to raise revenue by taxation. It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation."

Subsequent decisions of this Court have stressed the importance of this annual accounting principle. The importance of proper accounting for the depreciation of physical assets was stressed in *Massey Motors v. United States*, 364 U.S. 92 (1960), and the Court stressed the importance of allowing a deduction for amortizable intangibles in *Newark Morning Ledger Co. v. United States*, 507 U.S. 546 (1993).

The annual accounting principle plays a role in the calculation and timing of bad debt losses as well. The Fifth Circuit expressed it very well:

> "It is axiomatic that tax law treats each taxable year as a separate unit. Thus, a taxpayer must determine and file a return of his income and loss on an annual basis without benefit of hindsight. This same principle has been true in determining the worthlessness of a bad debt for a particular taxable year..." *Estate of Mann v. United States*, 731 F.2d 267 (5th Cir. 1984).

The Court went on to note that, in obedience to the annual accounting principle, subsequent events could not be used as evidence of the fact of worthlessness. Even subsequent recoveries on debt deducted as bad debts do not disqualify a timely and valid bad debt deduction. *United States v. S. S. White Dental Mfg. Co.*, 274 U. S. 398 (1927); *Textron, Inc. v. United States*, 561 F.2d 1023 (1st Cir. 1977).

A review of the opinions below is revealing in light of the annual accounting principle. The Eighth

Circuit summarily affirmed the United States Tax Court opinion. The United States Tax Court opinion points to several after the fact developments to support the conclusion that the Petitioner had not established the worthlessness of the debt:

1. The fact that the debtor (EPL) continued to operate;
2. Petitioner's continued advances to EPL after the debt was written off; and
3. The formation of a new business plan for EPL and an attempted public offering of its stock.

Thus, a review of the Tax Court opinion reveals that it primarily relied upon subsequent events for support of its conclusion, in violation of the annual accounting principle.

It should be pointed out that the above three specific facts happened because of a massive restructuring of the EPL's management, finances and operations. The cancellation of its debt to Petitioner was one part of that restructuring. The successful implementation of the other aspects of the restructuring lead to EPL's continued operations, the attempted public sale and Petitioner's later advances which were made under different circumstances from the original transfers which were deducted for 1988. These developments could not have been foreseen in 1988.

II. THE PETITION SHOULD BE GRANTED BECAUSE THE OPINIONS BELOW CONFLICT WITH THE PRECEDENTS OF THE FIFTH CIRCUIT CONCERNING THE USE OF SUBSEQUENT EVENTS TO ESTABLISH LACK OF WORTHLESSNESS WHEN A TAXPAYER CLAIMS A BAD DEBT LOSS.

The Fifth Circuit Court of Appeals has taken a position diametrically opposed to that adopted by the Eighth Circuit in the opinion below in regard to the use of hindsight to prove worthlessness. In *Brimberry v. Commissioner*, 588 F.2d 975 (5th Cir. 1979), a taxpayer sought to use subsequent events to substantiate his bad debt deduction for 1967 and 1968. The Court rejected that attempt stating that "hindsight is always 20/20. For purposes of review, the facts must be considered as they existed at the time the deduction was taken."

The tables were reversed in the *Estate of Mann v. United States*, supra. In Estate of Mann, the government contended that a subsequent recovery precluded a taxpayer from claiming a bad debt loss for an earlier year. The Court refused to look at subsequent events and referred to the annual accounting principle as highlighted in the preceding section.

III. A REVIEW OF THE CASES CONCERNING LOSSES CLAIMED PURSUANT TO SECTION 165 OF THE INTERNAL REVENUE CODE WHERE THE COURTS MUST DETERMINE IF A TAXPAYER HAS A REASONABLE PROSPECT OF RECOVERING THE LOSS BASED ON A CLAIM FOR REIMBURSEMENT SHOW THAT THE COURTS REJECT CONSIDERING FACTS NOT REASONABLY FORESEEABLE AS OF THE CLOSE OF THE RELEVANT TAX YEAR.

Cases from other circuits in a closely related area of the tax law reinforce the conclusion that the Eighth Circuit has erred in using "20/20 hindsight." The Internal Revenue Code, in Section 165, authorizes taxpayers to deduct any loss sustained during a tax year that is not compensated for by insurance or otherwise. Under Section 165, the Courts must consider an issue closely related to worthlessness: Does the taxpayer have a reasonable prospect for recovering under a claim for reimbursement? Treas. Reg. § 1.165-1(d)(2). The Fifth Circuit has held that "subsequent events should not be given determinative significance" in determining whether there was a reasonable prospect of recovery for the loss caused by the expropriation of a taxpayer's property in Iran as a result of the Islamic revolution in late 1978. *Halliburton Co. v. Commissioner*, 946 F.2d 395 (5th Cir. 1991). The Court required the parties to determine "reasonable prospect for recovery" based upon the facts and circumstances known at the end of the year in which the loss was deducted and rejected any

reference to any subsequent recovery or improved prospects for recovery in later years.

In *Jeppsen v. Commissioner*, 128 F.3d 1410 (10th Cir. 1997), the Tenth Circuit Court of Appeals considered the issue of whether a taxpayer's ultimate recovery should be considered in determining whether the taxpayer was entitled to claim a loss in the earlier year. The Tenth Circuit held that "neither the IRS nor the Tax Court may consider, in this context, facts not reasonably foreseeable as of the close of the pertinent tax year." Therefore, the Court implemented the annual accounting principle in considering the deductibility of losses under Section 165.

IV. THE PETITION SHOULD BE GRANTED BECAUSE A DETAILED COMPARISON OF THE PROPER APPLICATION OF THE ANNUAL ACCOUNTING PRINCIPLE IN THE FOLLOWING CASES DEMONSTRATES THE GRIEVOUS ERROR OF THE EIGHTH CIRCUIT AND THE UNITED STATES TAX COURT IN THIS CASE.

A detailed review of five of the cases cited above shows that the Eighth Circuit disregarded the annual accounting principle in its decision in this case in ways that conflict with the cases decided by other circuits.

For example, in *Estate of Mann*, *supra*, the taxpayer, a Dallas, Texas lawyer, advanced funds to his older brother's holding company totaling some $3 million dollars from 1967 through 1970. The loans were made

necessary by the business and cash flow problems of the older brother's holding company, Diversa Incorporated. Between 1967 and 1971, the brothers discussed repayments of the loans several times and agreed that the taxpayer would be repaid when money was available over and above the demands of more pressing creditors. The history of Diversa showed that it was undercapitalized from the beginning and when interest rates rose in 1967 and 1968, it came under serious financial strain. The loans were meant to help it through that strain but failed. A bankruptcy filing followed in early 1971. In 1976, the bankruptcy proceeding resulted in the taxpayer's estate receiving a distribution of less than $21,000 on his unsecured claims against Diversa in 1976.

In 1978, the taxpayer's estate filed a claim for a refund of about $1.5 million in taxes he had paid in 1968 and 1969. The estate asserted that the debts became wholly worthless in 1971, and as business bad debts, could be carried back to 1968 and 1969. On the issue of worthlessness, the government pointed to a subsequent event, the $21,000 distribution in 1976. With the language that we cited above, the Fifth Circuit rejected the government's contention and held that subsequent recoveries do not preclude otherwise valid deductions of bad debts.

In *Brimberry*, *supra*, the taxpayer loaned $175,000 to a church in New Orleans with the hope of acquiring a construction contract from the church. Within six months after making the loan, the Securities and Exchange Commission (SEC) filed a complaint against the church alleging securities fraud in connection with

the sale of church bonds. Approximately one year after the taxpayer made his loan, the church filed a Petition in the Bankruptcy Court for reorganization. At trial, the parties stipulated that financial statements accurately reflected the financial condition of the church except for a controversy over the value of the church's real property. The financial statements showed a deficit of approximately $275,000.

At the Fifth Circuit, the taxpayer argued that three events in subsequent years vindicated his claim of a bad debt deduction in 1967 and 1968. The first subsequent event that the taxpayer pointed to was the fact that the church property securing his note was sold in 1973 for an amount dramatically lower than the appraised value of that property. Second, the operating revenues of the church dropped at least 50% for the years of 1971 and 1972 from the revenues of earlier years. Finally, the church was still in reorganization proceedings in 1975, which the taxpayer argued indicated that substantial administration fees would be incurred. As noted above, the Court rejected such reference to hindsight "which is always 20/20." The Fifth Circuit held the facts must be considered as they existed at the time the deduction was taken. Thus, events must be reviewed in light of circumstances in 1968 and 1969. Therefore, the Fifth Circuit refused to allow the use of hindsight to support as well as oppose a bad debt deduction.

In *United States v. S.S. White Dental Mfg. Co., supra*, the taxpayer was a Pennsylvania corporation, which manufactured and sold dental supplies. It organized and owned all of the stock in a German subsidiary. It appears that the taxpayer made both an equity

investment in the German subsidiary as well as advancing funds on an open account.

In March 1918, as a result of World War I, the German government seized the property of the German subsidiary and took over management of its business. As a result of the mismanagement of its affairs while the German government operated the business and its use of the subsidiary's assets to purchase German war bonds, the value of its assets was seriously impaired. In 1920, the assets and business of the German subsidiary were returned to the subsidiary. In 1922, the subsidiary's assets were sold for a total of $6,000. In 1924, the taxpayer received $70,000 in compensation for its losses from a commission which had been established to consider such claims.

The taxpayer had taken a deduction, apparently both for a bad debt and worthless stock loss, for the entire amount of its debt and equity investment in the German subsidiary. The Supreme Court refused to consider the later sale in 1922 or the allowance of the claim in 1924 to influence its view that the debt was a valid bad debt and stock loss deduction in 1918. The Court pointed out that whatever amount the taxpayer would realize upon its loss would be dependent on the hazards of World War I, which was then in progress. To use the language of the Fifth Circuit Court of Appeals, the United States Supreme Court refused to resort to hindsight.

In *Halliburton Co. v. Commissioner*, *supra*, the taxpayer owned 25% of the stock in an Iranian barite mining venture for a cost of almost $1,000,000. In addition, in 1977 through 1979, it loaned this Iranian mining venture

almost $7,000,000. As a result of the Islamic revolution in Iran in late 1978, the Iranian government expropriated the mining facilities in which the taxpayer invested. In November 1979, Iranian militants seized American hostages at the American Embassy in Teheran, which of course lead to a worsening of relations between Iran and the United States of America. The parties agreed that the taxpayer could not realistically have pursued any claim in Iran because of the hostility between the United States and Iran. The Court noted that the taxpayer had no legal forum against Iran for the expropriation due to the "act of state" doctrine. As a result, the taxpayer concluded that by the end of 1979, its investment in the Iranian mining venture was worthless.

In late 1981, the taxpayer did file a claim in the Claims Tribunal, which was created in 1981 to hear claims American citizens might have against Iran. The taxpayer claimed approximately $10 million for its losses. It received almost $3 million on its claim in 1984. This later recovery was reported in its income in 1984.

The Commissioner of Internal Revenue disallowed the taxpayer's 1979 deduction asserting that the taxpayer had a claim for reimbursement to which there was a reasonable prospect of recovery at the end of 1979.

The United States Tax Court and the Fifth Circuit agreed that the use of subsequent events or "hindsight" could claim no role in considering whether there was reasonable prospect of recovery. The existence of a reasonable prospect of recovery "must be determined from the facts and circumstances known or which reasonably could have been known at the end of the

year" (quoting *Estate of Mann v. United States*, 731 F.2d 267 at 278). At the end of 1979, the taxpayer had no court to which it could appeal for redress against the actions of the Iranian government. No diplomatic arrangements existed at the end of 1979 that offered any hope of a recovery. Looking at all of the circumstances, the Tax Court concluded that the taxpayer had no reasonable prospect of recovering its losses as of the end of 1979. The Fifth Circuit affirmed this conclusion.

Finally, in *Rainbow Inn, Inc. v. Commissioner*, 433 F.2d 640 (3rd Cir. 1970), the taxpayer corporation conducted a retail food and liquor business in New Jersey. In 1962, a 25% shareholder who handled the books and records for the corporation embezzled approximately $33,000 from the corporation's bank account. The other two shareholders exercised a very lax supervision over the activities of the embezzling shareholder and they failed to detect the embezzlement loss for at least two months even though a cursory inspection of the bank statements would have shown serious discrepancies. The signatures of all three shareholders were required to issue a check and the embezzling shareholder simply forged the signature of the other two shareholders. At trial of the tax case, the parties apparently agreed that there was no chance of a recovery from the embezzling shareholder and by the time the case came to trial, none of the embezzlement loss had ever been reimbursed from any source.

The two shareholders who had not participated in the embezzlement caused the corporation to file a civil suit against the bank. They won an initial judgment from the trial court, which engaged in what the Third Circuit

described as a "feat of statutory construction that can only be described as aberrant." According to the Third Circuit, there was never "any real doubt that lack of due diligence in discovering the ongoing forgeries would provide the bank with a defense" against the corporation's suit. Nonetheless, the Commissioner of Internal Revenue attempted to use this temporary, and soon reversed, trial court victory to postpone the deduction to 1964 when the decision of the trial court was reversed on appeal.

The Third Circuit held that the Tax Court had erroneously relied upon the trial court opinion, entered in 1963, to hold that there was a reasonable prospect of recovery in 1962 when the loss deduction was claimed. The Third Circuit reasoned that a victory on the very thin legal theory being advanced by the non-embezzling shareholders could not have been foreseeable and therefore should not have been considered by the Tax Court in considering the validity of the deduction taken in 1962. Thus, the Third Circuit Court of Appeals has held that hindsight should not be used to invalidate an otherwise valid loss deduction.

To summarize, these Courts have refused to use subsequent events to either confirm or deny the deductibility of a deduction for a bad debt or other loss. In *S.S. White Dental Mfg. Co., supra, Halliburton, supra*, and *Jeppsen, supra*, later recoveries on claims for reimbursement of various types of losses were not allowed to defeat a deduction of the loss in the year in which it occurred. In *Estate of Mann, supra*, a subsequent bankruptcy distribution was not allowed to defeat a properly claimed bad debt deduction. Finally,

in *Brimberry, supra*, the subsequent sale of real estate securing a debt and a drop in revenues for the debtor, occurring subsequent to the year in which the bad debt loss was claimed, were not allowed into consideration to establish a claim to bad debt deduction.

In this case, the three subsequent events cited by the United States Tax Court and relied upon by the Eighth Circuit in its summary affirmation of the United States Tax Court Opinion should not be allowed to defeat the bad debt deduction. These three events are: first, the continued operation of EPL; second, the continued advances to EPL after the bad debt deduction based on a new arrangement and an entirely reorganized EPL; and third, the formation of a new business plan for EPL and later attempted public offering of its stock. All three of these events occurred after December 31, 1988. All are based on EPL's successful operations after that date. As of December 31, 1988, none of these events were foreseeable. None of these events should be considered in determining the worthlessness of EPL's debt to Petitioner as of December 31, 1988.

V. THE PETITION SHOULD BE GRANTED BECAUSE THE OPINIONS BELOW FAIL TO PROPERLY TAKE INTO ACCOUNT THE FACT THAT THE INTERNAL REVENUE SERVICE, IN ITS ROLE AS A CREDITOR OF EPL, ESSENTIALLY DECIDED THAT PETITIONER'S DEBT WITH EPL WAS WORTHLESS WHEN IT ACCEPTED AN OFFER IN COMPROMISE ON ACCRUED BUT UNPAID FEDERAL PAYROLL TAX OBLIGATIONS.

As noted in the discussion of the facts of the case, among the debts that EPL owed third parties was a payroll tax obligation to the Respondent in this case, the Internal Revenue Service. The Internal Revenue Service decisions to accept an Offer in Compromise of the amount of payroll taxes owed to it by EPL were made in 1989 and 1990. In other words, at a time when the Internal Revenue Service did not have the benefit of significant hindsight, it decided that the Internal Revenue Service interests in the assets of the corporation had very limited value.

Even though the balance sheet for December 31, 1988 showed readily marketable assets consisting of accounts receivable ($142,426), inventory ($117,708), furniture and equipment ($49,081) and vehicles ($13,116) totaling $322,331, the Internal Revenue Service decided that the amount offered, $272,460.90 greatly exceeded what the Internal Revenue Service could realize on the forced sale of these assets. The Internal Revenue Service report recommending acceptance of the proposed Offer in Compromise pointed to the great difficulties in realizing

significant amounts from the sale of the inventory. Without the benefit of hindsight concerning the improved operation of EPL through restructured management, an improved balance sheet and better focus on fewer product lines, the Internal Revenue Service made a determination that was very similar to Petitioner's decision concerning his prospects for repayment of his debt. Only with the later hindsight did the Internal Revenue Service decide to disallow this debt.

The Internal Revenue Service's conclusion that it would receive far less than the amount offered as an offer in compromise is especially revealing and conclusive given the lien priority position available to the Internal Revenue Service upon the filing of a Notice of Federal Tax Lien. I.R.C. §§ 6321, 6322, 6323 . A federal tax lien filed as of a certain date will take priority over later filed security interests. In regard to accounts receivable and inventory, the Internal Revenue Code provides a special rule. New accounts receivable are continually being created and new inventory acquired over the life of a business. Therefore, once a federal tax lien is filed, the federal tax lien and a previously filed security interest of another creditor will attach simultaneously to the newly acquired accounts receivable and inventory. Therefore, a special rule in the Internal Revenue Code protects a creditor with a previously filed security interest in accounts receivable and inventory for 45 days after the filing of the tax lien.. I.R.C. § 6323 (c)(1) and (2)(B). During that 45-day period, the earlier filed security interest will have priority over the federal tax lien. Accounts receivable and inventory acquired after

that date by a taxpayer are subject to the Internal Revenue Service's tax lien.

Even with such a priority position in accounts receivable and inventory, or the ability to establish such a position merely by filing a tax lien, the Internal Revenue Service concluded that its ability to collect on the assets of the corporation fell far short of the amount offered by Petitioner on behalf of EPL: $272.460.90. Even after removing this amount (unpaid payroll taxes due to the Internal Revenue Service), debt to third parties, other than Petitioner, of $905,731.10 would remain as of December 31, 1988. Therefore, very close in time to when Petitioner decided that EPL's debt to him was worthless, the Internal Revenue Service decided that it's prior claim against EPL for unpaid payroll tax obligations should be settled for less than the full amount because of the dubious value of the readily marketable assets of this corporation. It should also be noted that other creditors had obtained security interests in the assets of the corporation that took priority over Petitioner's unsecured claims against the corporation. Also, Petitioner's claims were frequently subordinated to those of secured creditors. Therefore, at the end of 1988, both the Internal Revenue Service and the Petitioner reached a very similar conclusion about this corporation's solvency and ability to pay its debts. The Internal Revenue Service claim alone would come very close to exhausting the book value of the readily marketable assets listed above. Before any such assets could be sold and the amounts distributed to Petitioner, the secured creditors of the corporation would have first claim. The Petitioner would be displaying "incorrigible optimism" if he expected to recover any of the debt at

issue in this case. *United States v. S.S. White Dental Mfg. Co., supra.*

CONCLUSION

The Court should grant a Writ of Certiorari for this very important case. The opinions below contradict the clear precedents of this Court and other circuits in applying the annual accounting principle to the determination of the worthlessness of bad debts. The opinions below use subsequent events to invalidate a bad debt deduction. This case presents the Court with an opportunity to reaffirm the importance of the annual accounting principle and restrict both the respondent and trial courts to the consideration of the facts that should be properly considered, those facts known and reasonably foreseeable at the time that a bad debt deduction is claimed by a taxpayer.

Accordingly, the Petitioner respectfully requests that the Petition for Writ of Certiorari be granted.

Respectfully submitted
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No. 99-1646

UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Robert C. Coborn, Sr.,
Appellant,

v.

Commissioner of Internal Revenue,
Appellee.

December 15, 1999, Submitted

December 23, 1999, Filed

JUDGES:
Before WOLLMAN, Chief Judge, FAGG, Circuit Judge, and BATTEY, * District Judge.

* The Honorable Richard H. Battey, United States District Judge for the District of South Dakota, sitting by designation.

OPINION:

PER CURIAM.

Having contested the Commissioner of Internal Revenue's federal income tax deficiency determination, Robert C. Coborn, Sr. appeals from the tax court's ruling upholding the Commissioner's decision that Coborn was not

entitled to claim a nonbusiness bad debt deduction on his federal income tax returns for the years 1988 through 1991 because Coborn failed to establish the indebtedness was worthless. After careful review of the record and the parties' briefs and arguments, we find no error in the tax court's ruling. We thus affirm on the basis of the tax court's opinion.

Tax Ct. Dkt. No. 16842-94

UNITED STATES TAX COURT

ROBERT C. COBORN, SR.,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

October 19, 1998, Filed

COUNSEL:
David L. Zoss, for respondent.

Mark A. Pridgeon, for petitioner.

JUDGES:
SWIFT, JUDGE.

OPINIONBY:
SWIFT

OPINION:

MEMORANDUM OPINION

SWIFT, JUDGE: Respondent determined deficiencies of $249,919, $96,478, $5,627, and $16,300, respectively, in petitioner's Federal income taxes for 1988, 1989, 1990, and 1991.

The issue for decision is whether petitioner is entitled to a claimed $1.6 million nonbusiness bad debt deduction relating to funds transferred to a closely held corporation.

BACKGROUND

Petitioner resided in St. Cloud, Minnesota, at the time the petition was filed.

On June 16, 1972, petitioner became holder of stock in Environmental Protection Laboratories, Inc. (EPL), a newly formed Minnesota corporation established, among other things, to develop products relating to laboratory testing and to environmental monitoring equipment.

Beginning in 1983 and through January of 1990, petitioner was the controlling shareholder of EPL. One of petitioner's business objectives for EPL was for EPL to become sufficiently successful and profitable so that the stock in EPL could be sold to a third party at a large profit.

In 1983, petitioner's son, Robert C. Coborn, Jr., became EPL's president. Over the years, petitioner invested heavily in EPL, in part, to financially support the corporation of which his son was president.

In the early 1980's, it was estimated that EPL would need $1.5 to $1.9 million in additional capital funds to implement for EPL the business plan that petitioner, his son, and others had developed.

Between 1972 and 1988, petitioner transferred at least $1,571,429 to EPL.

Over the years, EPL obtained a number of loans from banks. These loans were personally guaranteed by petitioner. Funds that petitioner individually transferred to EPL were not secured and were subordinated to bank loans EPL obtained.

Not until September of 1990 did petitioner take steps to secure funds he alleges to have loaned to EPL.

Between 1973 and 1984, a series of purported promissory notes were executed on behalf of EPL and in favor of petitioner that apparently related to some of the funds petitioner transferred to EPL. Neither petitioner nor EPL,

however, maintained adequate, current documentation and accounting records reflecting funds petitioner transferred to EPL. Certain documentation relating to the funds petitioner transferred to EPL appears to have been originated not at the time the funds were transferred but in later years.

Of the $1,571,429 that petitioner alleges constituted funds he loaned to EPL, $729,248 thereof is not reflected by any purported promissory notes.

At some point in time, an undated document was executed on behalf of EPL and in favor of petitioner indicating that petitioner agreed to loan over an unspecified period of time an unspecified amount of funds to EPL and that EPL would repay the funds on demand with interest at a rate of 14 percent per annum.

On petitioner's Federal income tax returns for the years in issue, the reporting of interest income by petitioner relating to funds petitioner received from EPL and relating to the alleged loans petitioner purportedly made to EPL is erratic and inconsistent. In some years, petitioner received no funds from EPL, but petitioner reported on his income tax returns interest income received from EPL. In other years, petitioner reported on his income tax returns more or less in interest income than the total funds he received from EPL. In some years, petitioner reported none of the funds he received from EPL as interest income. The schedule below indicates, for some years, the amounts of funds petitioner apparently received from EPL and the amounts petitioner reported on his respective Federal income tax returns as interest income received from EPL:

Year	Funds Petitione from EPL	Received Funds Report- As Interest Income
1979	-0-	$ 4,965
1984	$ 2,400	6,286
1985	-0-	14,125

1986	52,469	-0
1987	45,267	3,600
1988	48,454	6,000

On a final decree of divorce between petitioner and his wife dated January 12, 1987, it is stated that petitioner is awarded debt owed by EPL to him in the amount of $591,606.

In July of 1988, apparently before petitioner made any claim that the debt purportedly owed to him by EPL was worthless, EPL's financial statements for 1986 were prepared and reflected total assets of $3,029,877 and total stockholder equity of $552,097. Included among the reported assets was an asset with a stated value of $2,369,810 that was described as "Fair Market Value of Product Rights". In September of 1990, apparently after petitioner made the claim that purported debt owed to him by EPL was worthless, EPL's financial statements for 1987 and 1988 were prepared, and the above asset was omitted from the financial statements.

EPL experienced some degree of success. Between 1983 and 1987, EPL's gross receipts increased by over 400 percent. According to EPL's books, however, from 1984 through 1987, no net profits were realized by EPL, and EPL had a negative net worth. In 1988, EPL became delinquent in the payment of employment taxes, and EPL's board of directors considered filing a bankruptcy petition.

Petitioner and his son, however, decided not to file a bankruptcy petition on behalf of EPL because such a step would disrupt EPL's employee, vendor, banking and customer relationships and would damage EPL's trade name. Further, in 1988, petitioner and his son still considered EPL's business prospects good, and petitioner anticipated the possible private or public sale of the stock of EPL.

In 1988, no appraisals relating to the value of EPL as a business were obtained.

The evidence does not indicate that petitioner ever made demand on EPL for repayment of his purported loans to EPL, nor does the evidence indicate that petitioner ever undertook steps to otherwise collect from EPL the purported loans.

In 1988, in anticipation of, among other things, a possible sale of EPL's stock and in an effort to enhance the financial statements of EPL, petitioner went through the exercise of "forgiving" $1.6 million in purported debt of EPL to petitioner relating to funds that petitioner over the years had transferred to EPL.

After 1988, EPL continued to operate as a business. Petitioner and his son attempted to sell the stock of EPL in a public offering, and petitioner continued to transfer funds to EPL. In 1989, 1990, and 1991, petitioner transferred to EPL funds totaling $616,169, and petitioner received from EPL funds totaling $573,282. The evidence does not indicate the existence of any promissory notes or other debt instruments relating to the funds that petitioner, after 1988, transferred to EPL.

In 1989, in seeking outside investment capital, a new comprehensive business plan for EPL was adopted.

By 1992, EPL had changed its name to Micro Bio Logics, Inc. (MBL), and in 1992 MBL conducted an unsuccessful public offering of its common stock and warrants.

On EPL's original and amended 1988 corporate Federal income tax returns, $1.6 million in forgiveness of indebtedness income was reported relating to the $1.6 million in purported debt to petitioner that petitioner in 1988 allegedly forgave.

Based on EPL's 1988 corporate Federal income tax return, but for the $1.6 million in forgiveness of indebtedness income that was reported, EPL would have reported on its 1988 corporate Federal income tax return a net operating loss for 1988 in the amount of $717,119.

As a result of its 1988 operations and its net operating loss carryforward from prior years, the $1.6 million in forgiveness of indebtedness income that EPL reported for 1988 did not result in any reported tax liability for EPL.

Further, in January of 1988, petitioner sold his stock in Coborn's, Inc. (Coborn), another closely held corporation in which petitioner had an interest, and petitioner realized from this sale a long-term capital gain of $2,044,988. In 1988, 1989, 1990, and 1991, petitioner recognized and reported $855,089, $451,494, $30,786 and $34,730, respectively, of this capital gain.

On petitioner's 1988, 1989, 1990, and 1991 Federal income tax returns, the $1.6 million claimed nonbusiness bad debt deduction (and the carryovers thereof) relating to petitioner's purported loans to EPL significantly offset the capital gains reported from the sale of petitioner's stock in Coborn.

DISCUSSION

Losses on nonbusiness bad debts are treated as sustained in a particular year only if the entire debt becomes totally worthless during the year. *Riss v. Commissioner, 478 F.2d 1160, 1165- 1166 (8th Cir. 1973)*, affg. in part and remanding *56 T.C. 388 (1971)*; sec. 1.166-5(a)(2), Income Tax Regs. The taxpayer must show some identifiable event or group of facts that proves worthlessness. *American Offshore, Inc. v. Commissioner, 97 T.C. 579, 593-594 (1991)*. A debt does not become worthless merely because a creditor decides not to enforce the debt. *Southwestern Life Ins. Co. v. United States, 560 F.2d 627, 644 (5th Cir. 1977)*. Declining business, lack of profits, or poor financial condition do not necessarily establish worthlessness of a debt. *Intergraph Corp. v. Commissioner, 106 T.C. 312, 323 (1996)*, affd. per curiam without published opinion *121 F.3d 723 (11th Cir. 1997)*. This is particularly true where a debtor continues to operate as a going concern and where the creditor continues to extend

funds to the debtor. Id. and cases cited therein.

The evidence establishes that, after 1988, EPL continued to operate as a business. Petitioner continued to seek a sale of the stock of EPL, and EPL conducted ongoing business activity. In 1989, a new business plan for EPL was formulated, and in 1992 a public offering of EPL stock occurred. Significantly, after 1988, petitioner continued to transfer funds to EPL. The evidence does not demonstrate that EPL's purported debt to petitioner became worthless in 1988.

For the reasons stated,

Decision will be entered for respondent.